ECB between a rock and a hard place

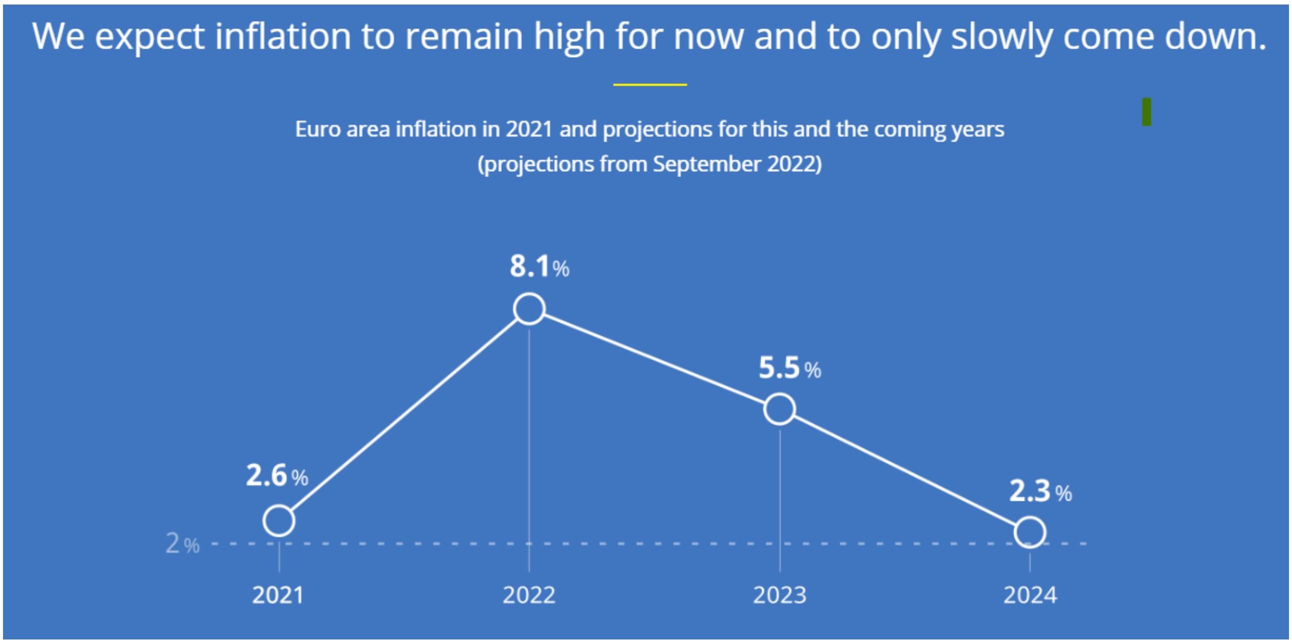
The ECB has delivered a jumbo interest rate hike of 75bp, which has only happened once before, at the introduction of the euro. Given strong indications that it will raise interest rates again at future meetings, the era of a "highly accommodative level of policy rates" is effectively over.

Between a rock...

After much hesitation, the ECB has had to adjust its forecasts for growth and inflation, which has led to significant revisions in the outlook for the eurozone economy.

The mantra that inflation was only temporary, and would retreat to the 2%-level, has been replaced with "we expect inflation to remain high for now ..." (cf. Figure 1, below).

Figure 1 ECB - inflation outlook *source ECB*

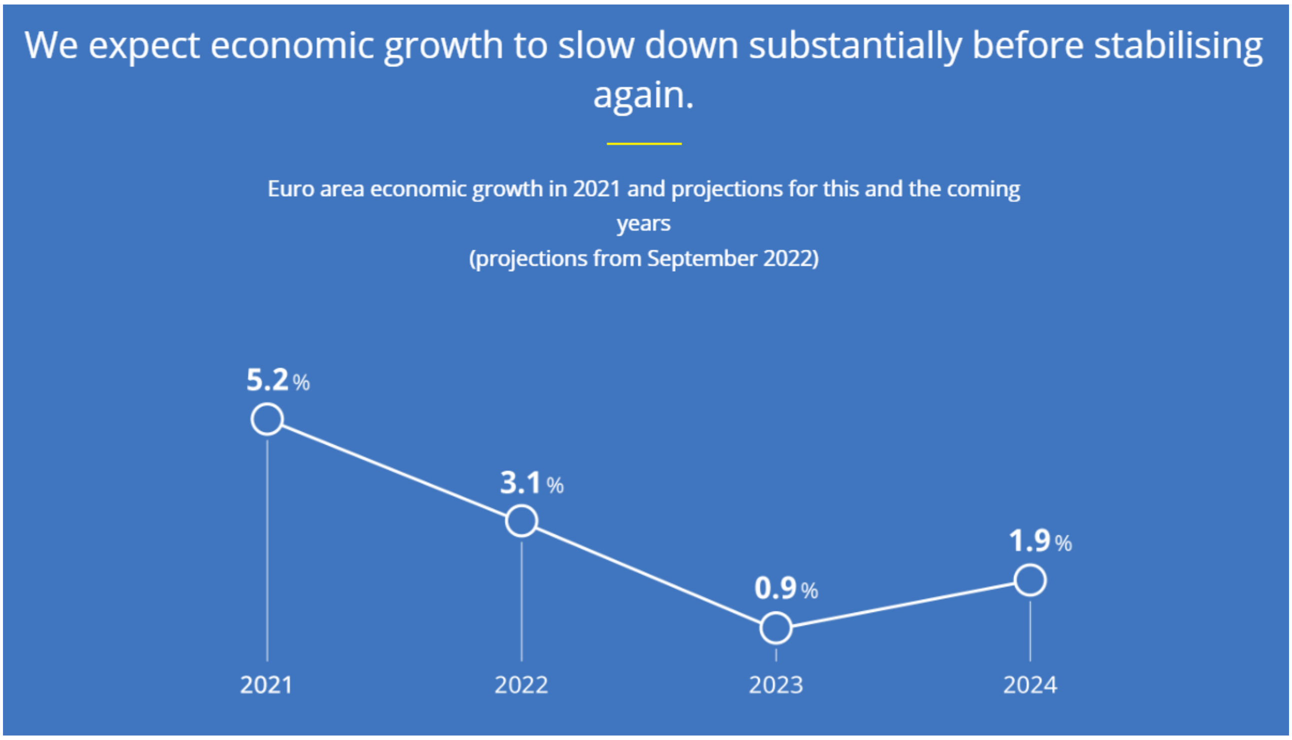


This forecast might even be on the optimistic side, given that eurozone inflation is currently at 9.1% yoy (August 2022). As Madame Lagarde stated in the ECB press conference on 8 September, risk regarding inflation is to the upside.

...and a hard place

Inflation is still rampant, and there has been no obvious impact yet from already slowing growth rates. As for growth, the ECB expects it to fall to 0.9% in 2023, without inflation declining to anywhere near its target zone of 2% (cf. Figure 2, below).

Figure 2 ECB - growth outlook *(source ECB)*



Whereas there is upside risk to the ECB's inflation forecast, President Lagarde warned of downside risks to its growth forecast.

The ECB is now in a position where it will have to continue to tighten monetary policy to combat inflation, despite acknowledging that growth rates are falling; it is truly caught between a rock and a hard place, especially since changes in monetary policy normally take 6-12 months to filter through to the underlying economy.

Monetary policy going forward

The ECB is not the only central bank which has had to re-evaluate its monetary policy.

Chair Powell of the Federal Reserve did not mince his words in a speech he gave at Jackson Hole on 26 August:

> *"Restoring price stability will take some time and requires using our tools forcefully to bring demand and supply into better balance. Reducing inflation is likely to require a sustained period of below-trend growth. Moreover, there will very likely be some softening of labour market conditions. While higher interest rates, slower growth, and softer labour market conditions will bring down inflation, they will also bring some pain to households and businesses. These are the unfortunate costs of reducing inflation. But a failure to restore price stability would mean far greater pain."*

US inflation data for August were not encouraging for the Fed, with overall inflation rising to 8.3%. The year-on-year rate did fall, but not as much as expected. This was mainly caused by an increase in food prices which almost offset the fall of more than 5% in energy prices.

While the Federal Reserve and the ECB have been behind the curve for some time, they are now trying very hard to regain control of inflation. However, as emphasised by Madame Lagarde, the inflation risk is clearly to the upside and prices might be a lot "stickier" than central bankers are hoping for.

Without any sugar coating, the central banks, especially the Fed, have signalled that they will do whatever it takes to rein in inflation, including perhaps allowing the economy to experience "a sustained period of below trend growth", i.e. recession.

The implication for interest rates in the eurozone is that the ECB will continue to raise them for the foreseeable future. The ECB's main refinancing rate is currently at 1.25%, and will likely be at or above 2% after the next 2-4 council meetings.

In our assessment, we are not as optimistic about inflation coming down as quickly as the current ECB forecasts suggest, which implies a further tightening of monetary policy in 2023.

Impact on alternative lending and Quantrom

Market-related interest rates have increased significantly during the last 6-9 months and, given the fact that more monetary policy tightening is on the horizon, we expect these interest rates to remain high, at least until inflation retreats to within the central bank's target zone.

At Quantrom, we will therefore adjust our long-term return target from 5% to 7% from the beginning of the fourth quarter of 2022.

This will bring back the long-term return target to the level it was at before the central banks adopted their very accommodative monetary policy.